Supreme Court, U. S.
FILED
MAY 20 1976
MICHAEL RODAK, JR., CLERK

No. 75-1374

In the Supreme Court of the United States

OCTOBER TERM, 1975

CAM F. DOWELL, JR., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,

SCOTT P. CRAMPTON,
Assistant Attorney General,

ELMER J. KELSEY,
F. ARNOLD HELLER,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1374

CAM F. DOWELL, JR., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. IV) is reported at 370 F. Supp. 69. The opinion of the court of appeals (Pet. App. I) is reported at 522 F.2d 708.

JURISDICTION

The judgment of the court of appeals (Pet. App. II) was entered on November 7, 1975. A petition for rehearing was denied on December 29, 1975 (Pet. App. III). The petition for a writ of certiorari was filed on March 26, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioner adequately substantiated claimed travel and entertainment expenditures in accordance with the requirements of Section 274(d) of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Section 274(d) of the Internal Revenue Code of 1954 (26 U.S.C.) and Sections 1.274-5(b)(3)(v) and 1.274-5 (c)(1) and (3) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth at pp. 2-4 of the petition. Sections 1.274-5(b)(1) and 1.274-5(c)(2)(i) of the Treasury Regulations are set forth in the Appendix, *infra*, p. 9.

STATEMENT

During 1964 through 1967, petitioner Hillcrest State Bank paid club bills, hotel bills, and travel charges incurred by or on behalf of its president and chairman of the board, petitioner Cam F. Dowell, Jr.[1] These payments were charged to Hillcrest's "dues, subscriptions and entertainment" account and claimed by it as business expense deductions on its tax returns. Hillcrest also paid Dowell a total of $150 per month in the form of two checks for $75, which were charged to Hillcrest's "traveling" account and its "dues, subscriptions and entertainment" account. Hillcrest similarly deducted this $150 monthly payment as business expenses. On audit, the Internal Revenue Service disallowed Hillcrest's deductions for these payments and included them in Dowell's gross income as dividends (R. 69-75).[2]

During 1965 through 1967, Dowell incurred expenses in connection with his private business interests which he characterized in his records as for "travel and entertainment," "fees," "auto expense," and "advertising." Although Dowell claimed portions of those expenses

[1]Evelyn Dowell is a party because she filed a joint return with her husband.

[2]"R." refers to the record appendix filed in the court of appeals.

as business expense deductions on his tax returns, the Internal Revenue Service disallowed most of them on audit (R. 75-81).

At the trial of this refund suit brought by Hillcrest and Dowell, they introduced into evidence a number of bills, chits and other papers relating to Dowell's travel and entertaining. Many of these documents were monthly statements that did not contain any information with respect to the dates or amounts of the expenses, or, in some instances, the location at which the expense was incurred (see, *e.g.*, R. 151-156, 314-322). Moreover, none of the documentary evidence contained the necessary contemporaneous record of the business purpose of the expenditure or the business relationship of the persons entertained.[3]

In an attempt to supply the missing factual data required by Section 274(d) of the Code to substantiate the deductions, petitioners Dowell and Hillcrest called more than 20 witnesses who testified as to Dowell's dedication to and total absorption in the business affairs of Hillcrest and his own business interests. But while most of the witnesses testified to having periodic business luncheons, dinners or meetings with Dowell at numerous clubs or restaurants, and provided general descriptions as to the type of business usually discussed at such functions, most of them could not identify the particular dates on which they had dined with Dowell, the place of the entertainment, the specific business discussed, or the amount of any bill.

[3]A number of the statements indicated what may well have been purely personal expenditures (see, *e.g.*, R. 310-313). Moreover, there was no documentation with respect to the use made of the $150 which Dowell received from the bank every month, nor did Dowell maintain a diary or account book recording the expenditure of these amounts (R. 152).

The district court did not make any findings on substantiation on an expenditure-by-expenditure basis. Instead, it made a general determination, based on the volume of documentary evidence and testimony, that petitioners had adequately substantiated their deductions under Section 274(d) of the Code (Pet. App. IV). It accordingly upheld the refund claims of Hillcrest and Dowell (R. 336-343).

The court of appeals vacated and remanded the case to the district court (Pet. App. I). It held that Section 274(d) provides that taxpayers cannot deduct expenses unless they substantiate, either through adequate records or through their own statements corroborated by other evidence, each and every element (amount, date, place, business purpose and business relationship) of each expenditure for travel and entertainment (Pet. App. I A-7). It therefore concluded that the district court's general determination that petitioners substantiated their expenditures did not meet the standard of Section 274(d). As a result, the court of appeals vacated the district court's judgment and remanded the case for it to determine whether each expenditure was adequately substantiated (Pet. App. I A-10 to A-11).

ARGUMENT

1. Section 274(d) of the Internal Revenue Code of 1954 provides that no deduction shall be allowed for any travel or entertainment expense until the taxpayer substantiates by adequate records or by sufficient evidence corroborating his statement (A) the amount of the expense; (B) the time and place it was incurred; (C) its business purpose; and (D) the business relationship to the taxpayer of the persons entertained. The legislative history of Section 274 demonstrates that its purpose was to end the deduction of uncorroborated est-

imates of entertainment and travel expense, which were often inflated and included personal expenses. By requiring substantiation of each claimed travel and entertainment deduction, Congress intended to end the abuses of the rule of *Cohan* v. *Commissioner*, 39 F.2d 540 (C.A. 2), under which a taxpayer could approximate a portion of his entertainment that was attributable to business. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 23 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 35 (1962).

Pursuant to Treasury Regulations, Section 1.274-5(c)(2)(i), the statutory term "adequate records" is defined as account books or diaries which, in combination with documentary evidence (such as receipts or bills) are sufficient to establish each element of the expense. In the absence of adequate records, Section 1.274-5(c)(3) of the Regulations permits substantiation by "other sufficient evidence" in the form of the taxpayer's own specific statement as corroborated by other evidence sufficient to establish the missing element. If the missing element is the amount, time or place of an expenditure, the corroboration must be by direct evidence; circumstantial evidence may be utilized in supplying business purpose or business relationship. Whatever the manner of proof, Section 1.274-5(b)(1) of the Regulations requires substantiation of each element of each separate expenditure.

As the court of appeals observed (Pet. App. I A-9), there is no question that the monthly statements introduced by Hillcrest and Dowell from billing organizations such as the Texas Club or American Express were insufficient to establish the specific time, amount or (in the case of the American Express stubs) the place of each separate expenditure comprising the monthly total. Since Dowell did not maintain a contemporaneous

account book or diary establishing the missing elements, there were no "adequate records" to substantiate his claimed deductions. Nor were the missing elements established by "other sufficient evidence," since the testimony of Dowell and the other witnesses was not specific. Thus, the court of appeals correctly held that the district court erred in upholding petitioners' claimed deductions.

There was likewise no substantiation of the $150 monthly payment by Hillcrest to Dowell for out-of-pocket expenses. Dowell testified (R. 147-148) that he used the money for parking in town or at the airport, for tips, taxicabs, for telephone calls or for "buying somebody coffee or Coca Colas or whatnot," but he kept no diary or account book of such expenditures (R. 152), and produced no evidence in corroboration of his own statement. While both the district court (Pet. App. IV D-10) and the court of appeals (Pet. App. I A-10) recognized the practical problems of recording each minor expense, the district court incorrectly determined that no substantiation was required. The court of appeals correctly held (Pet. App. I A-10 to A-11) that there is no exception for minor expenses in the substantiation requirements, and that any practical difficulties of substantiation are largely resolved by the Regulations, which permit aggregation of such expenditure in realistic related categories.

Petitioners argue (Pet. 8-12) that because Section 1.274-5(c)(3) of the Regulations permits corroboration of business relationship by circumstantial evidence, Dowell's general testimony to the effect that the majority of expenses were incurred for meals with customers, prospective customers, and directors, was sufficient to establish the business relationship of the expenses. But as the court of appeals observed (Pet. App. I A-10),

Section 274(d) requires substantiation of "the" business relationship, not "a" business relationship, and the business relationship of each person entertained on each separate occasion can only be ascertained by establishing with some specificity the identity of the person entertained. In the absence of such evidence, petitioners were not entitled to judgments in their favor and the court of appeals correctly so held. Unless petitioners can produce the required documentation on remand, the district court must dismiss their refund suits.

2. Contrary to petitioners' argument (Pet. 7-8), the decision below does not conflict with *LaForge* v. *Commissioner*, 434 F.2d 370 (C.A. 2). There, the taxpayer was a surgeon who regularly bought lunches in the hospital cafeteria for his assistants. He kept no written record itemizing the cost of the lunches, but deducted on his income tax returns $2 for each day of the hospital schedule. Although hospital rules forbade the cafeterias from issuing receipts, the cafeteria cashier testified that the taxpayer regularly spent $2.65 to $3.00 each day for the lunches. Despite the then-existing requirement of Section 1.274-5(c)(3) of the Regulations that the taxpayer have a contemporaneously written statement in support of the expense,[4] the court held that properly corroborated oral testimony may constitute adequate substantiation. However, because the taxpayer's testimony was not "sufficiently precise" under the regulation to establish the nondeductible portion representing the cost of his own lunches, the court remanded the case for further evidence.

---

[4]Section 1.2745(c)(3)(i) of the Regulations was subsequently amended to allow for a taxpayer's written or oral statement. See T.D. 7226, 1973-1 Cum. Bull. 153.

As the court of appeals noted (Pet. App. I A-8 to A-9, n. 10), *LaForge* is distinguishable. Unlike this case, there was no question in *LaForge* with respect to the place of the expenditures, and the taxpayer presented corroboration as to amounts, times and business relationships with respect to each expenditure. Moreover, the persons entertained came from a small, easily identifiable group whose business relationship was clear. Here, however, Dowell did not adequately substantiate his expenditures, and the large number of expenditures, the variety of places at which he entertained, and the many people he entertained call for detailed documentation that was unnecessary in *LaForge*. The significance of *LaForge*, as the Second Circuit subsequently explained in *Hughes* v. *Commissioner*, 451 F.2d 975, 979, "is that, even though a written statement may not be required for substantiation, the corroborative evidence must nevertheless establish each statutory element—amount, time, place and purpose—of the expenditure with precision and particularity." Accord: *Handelman* v. *Commissioner*, 509 F.2d 1067 (C.A. 2). Since petitioners failed to substantiate their claimed expenses in accordance with these statutory elements, the court of appeals correctly reversed the judgments in their favor.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

ELMER J. KELSEY,
F. ARNOLD HELLER,
Attorneys.

MAY 1976.

DOJ-1976-05

APPENDIX

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.274-5 *Substantiation requirements.*

* * * * *

(b) *Elements of an expenditure*—(1) *In general.* Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

* * * * *

(c) *Rules for substantiation*—* * *

(2) *Substantiation by adequate records*— (i) *In general.* To meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement of expense or similar record (as provided in subdivision (ii) of this subparagraph) and documentary evidence (as provided in subdivision (iii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

* * * * *